CC:TL-N-3625-89
Brl:CEButterfield

MAR 20 1990

District Counsel, Buffalo CC:BUF

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[redacted]
Non-docketed

This responds to your request for Tax Litigation Advice by memorandum dated February 8, 1989.

ISSUE

When a parent company forms a new DISC as a successor to a former DISC for the sole purpose of selecting a new fiscal year without asking permission of the Commissioner, as required under I.R.C. § 442 for continuing entities, whether the fiscal year of the new DISC will be recognized.

CONCLUSION

Even though the sole purpose of the formation of a new DISC was to circumvent the requirements of section 442, there is no basis in the Code, regulations, or case law for denying recognition to the new DISC on the fiscal year it elected on its first return.

FACTS

[redacted] formed its original DISC in [redacted], and consistently employed a calendar year for the reporting of income. In [redacted], knowing that legislative changes were under consideration that would prohibit deferrals through use of a DISC for tax years after 1984, a new DISC was formed, which adopted a [redacted] fiscal year. The corporate minutes reflect that the new DISC was formed solely to avoid the requirement of seeking permission for a change in accounting period by the old DISC, and that the fiscal year was adopted solely to effect a tax saving for the short period and the first 12 month year. There was no business purpose that would have been sufficient to gain permission for the change had the old DISC sought to make one. The revenue agent estimates that a total tax deferment of $[redacted] was accomplished through the means of forming a new DISC.

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In your request you mentioned that you had discussed this question with Ms. Sara Yost, of Income Tax & Accounting, and that the Revenue Agent stated that he spoke to someone in International. We have coordinated our response with both IT & A and International, to insure agreement among the functions. IT & A, International, and this office independently reached the same conclusion.

LEGAL ANALYSIS

As you have stated in your memorandum, changes in the law subsequent to the formation of the new DISC in this case will prevent this issue from arising in future years. The anti-abuse provision found at Temp. Treas. Reg. § 1.442-2T(h) disallows the transfer of assets to a new entity to avoid the consent requirements of section 442. This addition to the regulation was made in a 1987 TD. Furthermore, for DISCs formed after March 21, 1984, section 442(h)(1) requires conformity between the fiscal year of the DISC or FSC and the reporting year of the shareholder or group of shareholders with the largest voting power. The Revenue Agent cites the anti-abuse provision in the regulations as support for his argument, and as a clarification of the state of the law before its addition to the regulations.

We view a subsequent amendment to regulations as tending more to support the taxpayer's argument than ours under these circumstances. The need for such a change indicates to us that the amendment was intended to preclude for the future a means of changing taxable years that had theretofore been allowable under the regulations.

The Explanation of Items also relies on section 269, and on the line of cases that allow the Commissioner to give effect to the substance of a transaction if the forms does not accurately reflect the substance. We do not view these cases as adequate support for a refusal to recognize the tax year of the new entity, where there is no allegation made that a new entity was not in fact formed, or that the taxpayer's books did not adequately document the change. We do not believe sections 269 (dealing with acquisitions) or 482 (dealing with misallocations of income between related entities) to be applicable to this situation, although we sympathize with the analogy drawn by the agent.

Some support for the agent's position can be found in certain revenue rulings, and in the case of American Coast Line, Inc. v. Commissioner, 159 F.2d 665 (2d Cir. 1947). American Coast Line involved a corporation which had been dormant for four

years, but had been kept alive in name by the annual payment of franchise taxes. It was clear from the facts of the case that taxpayer had gone to some lengths to reactivate the old corporation in order to avoid the expense of forming a new one, and under those circumstances was not at liberty to select a new fiscal year different from the year employed originally.

On the other hand, Rev. Rul. 60-51, 1960-1 C.B. 169 holds that a corporation inactive for eight years and in fact dissolved in all but name could be reactivated with a new accounting period without first seeking the approval of the Commissioner. The result in this ruling is expressly contrasted with that in Rev. Rul. 60-50, 1960-1 C.B. 150, in which a corporation is held not to have dissolved where, instead of winding up the old corporation, assets were transferred to a new corporation and immediately reactivated therein. Taken together these rulings imply that a successor entity may adopt a new taxable year when the facts of the particular case support the claim that a new entity has been formed. While suggesting that the short year accounts were created by a reconciliation of the books of the predecessor DISC, the agent does not provide facts that would indicate that the formation of a new DISC was a sham.

It is a principle of long standing that a taxpayer must file its return on the basis by which its books were kept. Jones Cadillac v. Commissioner, 16 B.T.A. 932, aff'd, 41 F.2d 141 (7th Cir. 1930). Moreover, a taxpayer may not retroactively change its records and adopt a new taxable year. Iron Mountain Oil Co. v. Alexander, 37 F.2d 231 (10th Cir. 1930). In this case, however, there is no indication that the taxpayer did not actually do what it purported to do -- form a new DISC and maintain records for it. Unless it could be shown that this formation did not take place, there is no basis to attack the use of a different reporting period by the new entity. See Vance v. Commissioner, T.C. Memo. 1989-95 and cases cited therein. While tax planning of this type is undoubtedly aggressive, we do not believe it can be attacked as illegal. IT & A and International concur in this conclusion.

If you have any questions with regard to this matter please contact Ms. Clare E. Butterfield, at (FTS)566-3442.

Sincerely,

MARLENE GROSS

By: _____

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